No. 11417

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NATIONAL RESERVE INSURANCE COMPANY, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

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CITATIONS

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OPINION BELOW

The opinion of the Tax Court (R. 20–37) and the dissenting opinion (R. 37–39) are reported at 6 T. C. 473.

JURISDICTION

The petition for review involves incomes taxes for the years 1939 and 1940 in the respective amounts of $1,087.59 and $734.53, total $1,822.12. (R. 21.) The taxpayer filed returns for these years with the collector for the District of Arizona. (R. 22.) On July 7, 1942, the Commissioner mailed a notice of deficiency to the taxpayer advising it of deficiencies in income tax for 1939 and 1940 in a total amount of $1,822.12.

(R. 13–18.) Within ninety days thereafter, on October 1, 1942, the taxpayer filed a petition with the Tax Court of the United States for a redetermination of the deficiencies, under Section 272 of the Internal Revenue Code. (R. 1, 4–18.) The decision of the Tax Court finding that there are no deficiencies in income tax for the years 1939 and 1940 was entered March 15, 1946. (R. 39.) The case is brought to this Court by petition for review filed by the Commissioner on June 3, 1946 (R. 40–44), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether the reserve fund, which was maintained by the taxpayer in the taxable years pursuant to Arizona law and its by-laws, not only for payment of claims but for other purposes as well, is a fund held for the fulfillment of life insurance contracts, so that taxpayer may be classed for tax purposes as a life insurance company within the meaning of Section 201 (a) of the Internal Revenue Code and Sections 19.201 (a)–1 and 19.203(a) (2)–1 of Treasury Regulations 103.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are printed in the Appendix, *infra,* pp. 39–49.

STATEMENT

The facts found by the Tax Court may be summarized as follows:

The taxpayer is an Arizona corporation, with principal office at Phoenix, doing business in the

taxable years under the provisions of the Arizona Benefit Corporation Law of 1937 (Arizona Code, Annotated, 1939, Sections 53–601 to 53–622, inclusive). The taxpayer's income tax return for 1939 reported a net loss of $21.18 and stated that the taxpayer was engaged in the "Assessment Insurance" business and was a non-stock, non-profit, mutual corporation. The taxpayer's return for 1940 reported a net loss of $5.80 and stated that the taxpayer was engaged in the life insurance business and was a non-stock, non-profit mutual corporation. (R. 22.)

In the taxable years the taxpayer issued only two types of life insurance policy. The "Individual or Group Life" policy provided for the placing in a "Reserve or Mortality Fund" of, after the first month, 25% of the first year's premium, and 66⅔% of all subsequent payments, for the purpose of payment of claims and expenses incidental thereto. The "Whole Life Insurance" policy carried the same provisions with respect to the Reserve or Mortality Fund, except that, after the first month, 50% of the first year's premium and 66⅔% of all subsequent payments were to be placed in the reserve or mortality fund. All policies issued prior to the taxable years carried the same provision as the Whole Life Insurance Policy, except one which incorporated the provisions of the taxpayer's by-laws into the policy. (R. 22–23.)

Article XVI of the taxpayer's by-laws provided for the creation and maintenance of a "Death Benefit Fund," to consist of 50% of the first year's assessment, less the first month's payment, and 66⅔% of

all subsequent payments except where a certificate had lapsed. (R. 23.) It was provided (R. 23–24):

> The money in the Death Benefit Fund shall be used for the payment of death losses, however, the Board of Directors may set aside a portion of the savings in said fund for the purpose of organizing a legal reserve life insurance company, and shall issue in January of every year beginning January 1936 a certificate of evidence to each member of the Association who has paid twelve consecutive monthly payments without lapsing, showing his or her pro rata in such savings.

Section 2 of Article XVI of the by-laws provided for the creation and maintenance of an expense fund to consist only of membership and registration fees, the first month's assessment and reinstatement payments, 50% of the next eleven months' payments, and 33 1-3% of all subsequent payments. (R. 24.)

The Arizona Benefit Corporation Law of 1937 required a corporation operating thereunder to state in every benefit certificate issued "the basis or amount to be set aside to the mortuary and reserve fund" and provided (R. 24–25):

> A mortuary and reserve fund, exclusive of other assets, may be created, out of which may be paid all benefit claims arising under the certificates, the deposits required to be made with the state treasurer as provided by section 608b, and attorney's fees and necessary expense arising out of the defense, settlement, or payment of any contested or disputed claim. The residue of payments made by members, after

> setting aside the amount required for the mortuary and reserve fund, and interest earned by the assets of the corporation, whether deposited with the state treasurer or otherwise invested, may be used for general operating expenses.

The Arizona law also provided for an examination and audit of the books and affairs of each benefit corporation at least biennially for the purpose of verifying the funds as provided in the benefit certificate. Under the law a benefit corporation was required to file a copy of its certificate with the Arizona Corporation Commission before soliciting business and within three days the Commission was required to issue a certificate of authority to transact business if the certificate conformed to the law. (R. 25–26.)

The Commission required any new insurance policy to provide, except for the first year, for the placing of not less than 50% of the premiums in a reserve, which was deemed sufficient to enable the reserve fund to meet all requirements of the American Standard Mortality Table on the basis of 3½% interest accretions. The Commission submitted the certificate copy filed with it pursuant to law to its actuary to ascertain whether its provisions met all requirements of law and of the Commission's rules and regulations with respect to the reserve fund set up for the protection of policy holders. (R. 26.)

In each year since 1937 the taxpayer has been examined by and has met the requirements of the Arizona Corporation Commission. (R. 26.)

The taxpayer allocated daily each premium payment to its mortality and expense funds in accord-

ance with the terms of its policies. (R. 29.) The receipts allocated to the mortality fund were credited monthly to an account on its general ledger entitled "Income—Premium Renewals—Mortality Fund." This account was charged with payments on policy claims, the expenses incidental thereto (such as telephone, telegraph, hospital bills, medical, notary, and attorney fees, and traveling expense), all of which were identified with specific policy claims, refunds of excessive premiums to policy holders, and certain minor general expense items ($34.99 in 1939, and $47.03 in 1940) not identified with any claim, which were erroneously charged to this fund. The expenses incidental to settling policy claims were not excessive. The refunds to policy holders were reflected in the general ledger account as "dividends" and were made as required by the Arizona Corporation Commission under the provisions of Bylaw XVI, relating to the savings in the death benefit or mortality funds. After refunding the savings to policy holders, the taxpayer's mortality fund or reserve was in excess of the reserve required by the Commission to protect policy holders. (R. 27–28.)

The assets, consisting of cash, a deposit with the state treasurer, secured loans, and government bonds, held by taxpayer in reserve for claim purposes at the end of 1939 and 1940, actually exceeded by small amounts the total reserve fund shown at the end of each year in its mortality fund. (R. 27, 109–111.)

Except for $206.92 received in 1940 as income from invested funds, the taxpayer's income during the tax-

able years was derived entirely from premiums. (R. 28–29.)

Upon these facts the Tax Court concluded, two judges dissenting, that the taxpayer maintained the reserves required by the laws of Arizona and its policy contracts; that more than 50% of its total reserve funds was held for the fulfillment of its life insurance contracts, and that taxpayer is entitled to be classed as a life insurance company within the meaning of Section 201 of the Internal Revenue Code and the applicable Treasury Regulations. (R. 29.)

STATEMENT OF POINTS TO BE URGED

The Tax Court erred in holding that the taxpayer was a life insurance company in the taxable years 1939 and 1940 within the meaning of Section 201 (a) of the Internal Revenue Code and the applicable regulations and in failing to find deficiencies for these years as determined by the Commissioner. (See R. 46–48.)

SUMMARY OF ARGUMENT

I. In order to be classed as a life insurance company for tax purposes, a corporation must fit within the definition of such companies contained in Section 201 (a) of the Internal Revenue Code. One requirement is that the company must hold a reserve fund for fulfillment of life insurance contracts which comprises more than 50% of the total reserve funds. Under the statutory definition, the regulations applicable thereto, and a further definition of reserve fund in Section 202 (b) of the Code which has been held applicable to assessment insurance companies by two Circuit

Courts of Appeals, it is clear that a fund must be maintained for the sole purpose of maturing claims under insurance policies in order to be considered as a reserve fund held to fulfill contracts. The courts have consistently taken this view.

The Tax Court's findings in this case show that the mortuary fund of the taxpayer, which was the only fund maintained by it other than an expense fund, was subject to be used lawfully under the provisions of Arizona law and of the taxpayer's by-laws and policies, to pay claims and expenses incidental thereto; to pay without limitation attorney's fees and the necessary expense of handling a contested or disputed claim; to make the deposit with the State Treasurer required by Arizona law which was only a deposit for the benefit and protection of taxpayer's members and was not itself available to fulfill claims arising under the taxpayer's contracts; to pay the savings in the fund for the expense of organizing a legal reserve life insurance company; to make refunds to policy holders of excessive premiums, in the nature of dividends; to apply the interest earned by the assets in the fund to payment of general expenses; and to pay hospitalization claims arising on health and accident policies. Under pertinent decisions and the long-standing definition of a reserve set out in the regulation, a fund held for any of such purposes is not a reserve in the technical sense in which it is used in the statute. It follows that the taxpayer maintained no fund which was a reserve fund held for fulfillment of contracts. Even if the mortuary fund

were assumed *arguendo* to be a reserve fund, in part, there is no basis on which it could be determined that more than 50% of the assets in the fund were held separately as a reserve with which to fulfill contracts. Accordingly, the taxpayer is not entitled to be classed as a life insurance company for tax purposes.

II. The taxpayer was clearly a mutual insurance company and is taxable as a mutual company other than life or marine under Section 207 of the Internal Revenue Code, as the Commissioner determined. The deficiencies found by the Commissioner on this basis appear to have been conceded to be correct, but in any case the taxpayer is not entitled to reduce the deficiencies by deducting the net addition required by law to be made to reserve funds or to the deposit with the State of Arizona under Section 207 (c) (1) (A) of the Code because it maintained no fund itself, or on deposit with the state, which qualifies as a reserve fund.

ARGUMENT

I

The taxpayer was not a life insurance company in the taxable years as defined in section 201 (a) of the Internal Revenue Code

The Internal Revenue Code contains special provisions (Sections 201–207, inclusive) dealing with insurance companies, which are divided for tax purposes into life insurance companies, insurance companies other than life or mutual, and mutual insurance companies other than life. The Commissioner determined that the taxpayer in the taxable years was a mutual insurance company other than life and sub-

ject to tax under Section 207 of the Internal Revenue Code (R. 15, 17). The Tax Court sustained the taxpayer's contention that it is taxable in these years as a life insurance company under Sections 201, 202, and 203 of the Code.[1]

In order to qualify as a "life insurance company" for tax purposes, the statutory definition of that term must be satisfied. Section 201 (a) of the Code (Appendix, *infra*) provides:

> When used in this chapter the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

Under this statute it is not enough that life insurance contracts are issued, but in addition the provision with respect to reserve funds must be precisely met. See *First Nat. Ben. Soc.* v. *Stuart,* 152 F. 2d 298 (C. C. A. 9th), certiorari denied, May 20, 1946; *First Nat. Ben. Soc.* v. *Stuart,* 134 F. 2d 438 (C. C. A. 9th), certiorari denied, 320 U. S. 211, in which this Court decided that

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[1] One advantage of classification as a life insurance company is that premium receipts are excluded from gross income. Under Section 202 (a) of the Code (Appendix, *infra*), the gross income of a life insurance company consists only of income received from interest, dividends, and rent, whereas there is no similar limitation with respect to the gross income of a mutual insurance company other than life under Section 207. Commencing with the Revenue Act of 1921 companies which met the statutory definition of life insurance companies have not been required to include premiums in gross income. See *Helvering* v. *Oregon Ins. Co.*, 311 U. S. 267.

an insurance company doing business in 1936, 1937, and 1938 under the Arizona Benefit Corporation Law (which, as amended in 1937, is involved in this case) was not a life insurance company as defined by statute for tax purposes in those years, for the reason that it failed to maintain a reserve fund for the fulfillment of life insurance contracts.

It is the Government's position in this case that the Tax Court erroneously classified the taxpayer as a life insurance company in 1939 and 1940, for the reason that the taxpayer's mortuary fund was not a reserve fund held for fulfillment of its life insurance contracts within the meaning of Section 201 (a) and the applicable regulations, since the fund was subject to use for purposes other than fulfillment of such contracts.

It is well settled that the term "reserve fund" as used in the revenue statutes in connection with life insurance companies has a technical meaning and refers to true life insurance reserves, in contrast to solvency or ordinary business liability reserves. See *Helvering* v. *Inter-Mountain Life Insurance Co.,* 294 U. S. 686; *Helvering* v. *Illinois Ins. Co.,* 299 U. S. 88; *Commissioner* v. *Oregon Mut. Life Ins. Co.,* 112 F. 2d 468 (C. C. A. 9th), affirmed, 311 N. S. 267; *Commissioner* v. *Monarch Life Ins. Co.,* 114 F. 2d 314 (C. C. A. 1st). The first sentence of Section 19.203 (a) (2)–1 of Treasury Regulations 103 (Appendix, *infra*) defines the term "reserve" in accord with its technical meaning, as explained by the Supreme Court in *Maryland Casualty Co.* v. *United*

States, 251 U. S. 342, 350, and Section 19.201 (a)–1 of the Regulations (Appendix, *infra*) provides that a reserve shall not be regarded as held for the fulfillment of an insurance contract within the meaning of Section 201 (a) of the Code unless it conforms to the definition of "reserve" in Section 19.203 (a) (2)–1.[2]

The most important characteristic of a life insurance reserve as recognized by Section 19.203 (a) (2)-1 of Regulations 103 is that it is set aside solely as a fund to liquidate future unaccrued and contingent claims arising under insurance contracts, or, as Section 201 (a) of the Code describes it, a fund held for the fulfillment of life insurance contracts. To be sure, Section 201 (a) does not expressly refer to a fund held exclusively for the fulfillment of contracts, but this is its only reasonable interpretation. If a fund is held to pay expenses and to make premium refunds in the nature of dividends, in addition to satisfying claims, the fund is not held for the fulfillment of contracts; it is held for various purposes, of which fulfillment of contracts is only one.

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[2] The phrase "held for the fulfillment of such contracts" should be contrasted with the term "total reserve funds" used in Section 201 (a) of the Code. The former refers only to a true insurance reserve as defined in Section 19.203 (a) (2)–1, whereas in *National Protective Ins. Co.* v. *Commissioner*, 128 F. 2d 948 (C. C. A. 8th), certiorari denied, 317 U. S. 655, the court held that "total reserve funds" included both a true life insurance reserve and a reserve fund held to liquidate claims on health and accident policies, even though this reserve did not conform to the technical requirements of a true insurance reserve fund.

Moreover, Section 201 (a) requires more than a mere fund held for fulfillment of contracts; it requires a "reserve fund" held for that purpose, and as has been seen under Section 19.201 (a)-1 of Treasury Regulations 103, a reserve fund within the meaning of Section 19.203 (a) (2)-1 of Treasury Regulations 103. That section makes it plain that a fund not maintained solely to liquidate or mature future claims arising under insurance contracts will not be regarded as a true reserve fund. While the Regulation does not use the word "solely," it points out that reserves maintained for purposes other than to pay claims, of which several examples are given (including reserves to pay dividends and expenses), are not included within the term "reserve." The Regulation does not purport to give an all-inclusive list of disqualifying purposes, other than for payment of claims, but, as the Regulation states, enumerates those listed by way of example only. Manifestly, if a fund is held in reserve for any purpose other than to mature or liquidate claims, even though such purpose is not specifically interdicted by the Regulation, it would not be a reserve held for fulfillment of contracts within the test of Section 19.203 (a) (2)-1.

We believe there can be no doubt as to the validity of the provisions of the Regulations in this respect. The Tax Court did not hold them invalid. The same provisions in substantially the same language have appeared in all the Regulations commencing with Treasury Regulation 86, promulgated under the Revenue

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Act of 1934,[3] and the fact that successive Revenue Acts did not disturb them discloses Congressional ratification.[4] *Helvering* v. *Reynolds Co.,* 306 U. S. 110, 115; *Helvering* v. *Winmill,* 305 U. S. 79, 83. In *First Nat. Ben. Soc.* v. *Stuart,* 134 F. 2d 438, certiorari denied, 320 U. S. 211, this Court held the regulations valid, and their validity was taken for granted in *First Nat. Ben. Soc.* v. *Stuart,* 152 F. 2d 298 (C. C. A. 9th), certiorari denied May 20, 1946. See also *Standard Industrial Life Ins. Co.* v. *Commissioner,* 42 B. T. A. 1011.[5]

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[3] Earlier regulations were phrased in somewhat different language but were similar in effect. See Articles 971 of Treasury Regulations 77 and 74; Article 681 of Treasury Regulations 69, 65, and 62.

[4] Far from disapproving the regulation, Congress has adopted it. In Section 163 (a) of the Revenue Act of 1942, it amended Section 201 of the Internal Revenue Code to provide a definition for the term "life insurance reserves" (as H. Rep. No. 2333, 77th Cong., 1st Sess., p. 109 (1942–2 Cum. Bull. 372), states) as—

> substantially that contained for many years in the regulations with the addition that the reserves must be based on recognized experience tables.

[5] *General Life Ins. Co.* v. *Commissioner*, 137 F. 2d 185 (C. C. A. 5th), did not hold the regulations invalid; it seems to have construed them as not requiring that a reserve be computed actuarially as distinguished from other methods of computation, so long as it was computed as required by law and was irrevocably dedicated to payment of claims. *Commissioner* v. *Swift & Co. E. B. A.*, 151 F. 2d 625 (C. C. A. 7th), held the regulations invalid only in so far as they require that the reserve funds referred to in Section 201 (a) must be required by law, a holding that is not in accord with the decisions of this Court in the *First Nat. Ben. Soc.* v. *Stuart* case, *supra*, or with the *General Life* case itself. As pointed out in the preceding footnote 4, Section 201 of the Code itself now defines "life insurance reserves" as, *inter alia*, those actuarially computed and required by law and the second requirement was held to be declaratory of existing law.

Moreover, there is a special statutory provision covering assessment insurance, which in the view of the Circuit Courts of Appeals for the Fifth and Tenth Circuits confirms our position here. The taxpayer was apparently operating under the assessment insurance plan. (R. 22, 96, 100–101.) [6] Section 202 (b) of the Internal Revenue Code (Appendix, *infra*) defines the term "reserve funds required by law," in the case of assessment insurance, as including amounts deposited with state officers as guaranty or reserve funds, and any funds maintained under the articles of incorporation exclusively for payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.[7] This definition of course applies to the term "reserve funds required by law" as used in Section 203 (a) (2), in the case of assessment insurance, but since Section 201 (a)–1 of the Regula-

[6] Its 1939 return stated it was engaged in the assessment insurance business (R. 22); its articles of incorporation stated its activities shall be carried on on the mutual assessment plan (R. 96); and its by-laws refer to amounts payable by members as assessments (R. 100–101).

[7] The taxpayer did not maintain its reserve fund under a specific provision of its articles of incorporation, but, instead, pursuant to Arizona law and provisions in its by-laws and policies. However, Section 202 (b) would seem to include reserves so maintained. The term charter or articles of incorporation used therein would probably comprehend by-laws, and, moreover, the provisions of state law are deemed to be incorporated in the charter, so that the charter in fact required a reserve fund as provided by state law, even though the requirement was not expressly stated. See *General Life Ins. Co.* v. *Commissioner*, *supra;* Cf. *Northwest Steel Rolling Mills* v. *Commissioner*, 110 F. 2d 286 (C. C. A. 9th), reversed on other grounds, 311 U. S. 46.

tions relates the term "reserve fund" in Section 201 (a) of the Code to the term "reserve" in Section 19.203 (a) (2)–1 of the Regulations and since that regulation defines a reserve for purposes of Section 203 (a) (2) of the Code, as well as for other purposes, it has been held that the Section 202 (b) definition applying to assessment insurance companies is pertinent in determining whether this taxpayer maintained a reserve fund within the meaning of Section 201 (a). See *Jones* v. *Oklahoma Benefit Life Assn.*, 151 F. 2d 505 (C. C. A. 10th); *General Life Ins. Co.* v. *Commissioner,* 137 F. 2d 185 (C. C. A. 5th).[8] Under those decisions, if, as we shall show, its reserves were

[8] *Commissioner* v. *Swift & Co. E. B. A.*, 151 F. 2d 625 (C. C. A. 7th), seems to have rejected the Tax Court's view that the term "reserve funds" in Section 201 (a) has the same meaning as in Section 203 (a) (2) and disapproved the regulations insofar as they prescribed that the reserves meant by Section 201 (a) must be those required by law. But this decision is contrary to the holding of this Court in *First Nat. Ben. Soc.* v. *Stuart*, 134 F. 2d 438, certiorari denied, 320 U. S. 211, and, moreover, the Seventh Circuit in the *Swift* case made no holding that Section 202 (b) does not apply in considering whether a fund of an assessment company meets the criteria contemplated by Section 201 (a) for a reserve fund. In *General Life Ins. Co.* v. *Commissioner*, *supra*, and *Jones* v. *Oklahoma Benefit Life Assn.*, *supra*, the courts both treated the definition of "reserve fund required by law" in Section 202 (b) as applicable to the term "reserve funds" in Section 201 (a). Furthermore, Section 163 (a) of the Revenue Act of 1942 amended Section 201 of the Code to incorporate the substance of Section 202 (b) into the general definition of reserves there contained. While the change was not made retroactive, the amendment does reflect an original intent that the definition in Section 202 (b), in the case of assessment insurance, also related to Section 201. Indeed, S. Rep. No. 1631, 77th Cong., 2d Sess., p. 32 (1942–2 Cum. Bull. 504), confirms that this was true under "existing law" prior to the amendment.

not maintained exclusively for payment of policy claims and were subject to other uses, they were not reserves within the meaning of Section 202 (b) and 201 (a) and the taxpayer does not qualify as a life insurance company.

The decisions also support the view that a fund will not qualify as a reserve fund held for fulfillment of contracts, within the meaning of Section 201 (a), unless the fund is held solely or exclusively for this purpose. In *First Nat. Ben. Soc.* v. *Stuart,* 152 F. 2d 298 (C. C. A. 9th), certiorari denied, May 20, 1946, this Court held that the Society, which did business under the same Arizona statute as is involved in this case, had not sustained its burden of proving, *inter alia,* that its reserve funds held for the fulfillment of contracts comprised more than 50% of its total reserve funds. In that case the evidence showed that the mortuary fund provided for in the Society's by-laws, but which in fact was not separately maintained, could be used for payment, not only of claims, but also of taxes, attorneys' fees, the deposit required by the State of Arizona, and expenses of handling claims. The District Court of Arizona had held in findings of fact and conclusions of law dated June 15, 1944 (See 33 A. F. T. R. 1643), that the Society did not maintain a reserve fund, but even if it had done so, the fund could have been used for taxes and other expenses so that it could not be deemed to have been held solely for fulfillment of insurance contracts, as Section 201 (a) of the Revenue Act of 1938 (identical with Section 201 (a) of the Internal Revenue Code) requires.

The District Court held further that since interest accretions from reserve funds could, under Arizona law, be used for general expenses, the fund departed from the requirements of Article 203 (a) (2)–1 of Treasury Regulations 101 (substantially the same as Section 203 (a) (2)–1 of Treasury Regulations 103) for such a fund. In affirming the District Court this Court expressed no disapproval of these conclusions.

In *General Life Ins. Co.* v. *Commissioner,* 137 F. 2d 185 (C. C. A. 5th), it was said (pp. 189–190):

> It is the universal concept that a life insurance company should maintain a reserve—not for its use but which it cannot invade—for the sole and exclusive protection of its policy holders. Since the reserve is held for the policy holders and not for the Company, Congress has not taxed this reserve as income to the Company. It is contemplated that the reserve is made up of money which the policy holder had put up for his own use and protection and not primarily for the use and protection of the Company. There is no apparent inequity in the policy of Congress in not planning to tax such reserve. However, this reserve should be irrevocably dedicated to the payment of claims arising under the policies. In a sense, it partakes of the nature of an inchoate trust for the benefit of policy holders.[9]

[9] In the *General Life* case the reserve fund could be used for payment of claims, and also, to a limited extent, for expenses of investigating, settling and contesting claims. The court seems to have overlooked the provision for payment of expenses in reaching the conclusion that the reserve funds in those cases were held for fulfillment of contracts, since the quotation above from the *General Life* case would demand a contrary conclusion upon the

Jones v. *Oklahoma Benefit Life Assn.*, 151 F. 2d 505 (C. C. A. 10th), recognizes the same principle. There the reserve fund itself could be used solely for payment of claims arising under policy contracts, but the interest earned by the fund could be used for payment of general expenses. The court pointed out that, under Oklahoma law and the association's by-laws, interest earned by the reserve fund is not a part of the fund; accordingly, that authority to use the interest for general expenses did not amount to use of the fund itself for payment of general expenses. The court held, one judge dissenting, that the mere investment of the fund to earn interest was not such a use of the reserve fund as to impair it or to amount to an expenditure for purposes other than payment of claims. Thus, it was concluded that the reserve funds themselves were held solely for payment of claims. It is implicit in the opinion that a fund which could be expended for other purposes would not meet the test of the statute.

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showing that the fund was not held exclusively for the payment of claims. Even if the court was of the view that payment from the fund of the expenses of contesting claims did not destroy its nature as one held solely to protect policyholders, a view which it did not state and which seems inconsistent with the *First Nat. Ben. Soc.* decision of the Arizona District Court, affirmed by this Court, *supra*, nevertheless the instant case presents a situation in which the reserve fund was not held solely to pay claims and expenses of paying or contesting claims. As will be shown, the fund here could be used to pay dividends and general expenses, to make deposits with the State Treasurer, and to organize a legal reserve insurance company. Hence, the taxpayer's reserve fund cannot, in any case, meet the test for a true reserve fund, even as exemplified by the *General Life* case.

Indeed, we know of no case which takes the view that a reserve fund not held exclusively for fulfillment of insurance contracts will suffice to classify a company as a life insurance company under Section 201 (a).

It is not entirely clear whether the Tax Court in this case understood that the term "reserve fund" in Section 201 (a) refers to a fund held solely for the payment of claims. (See R. 32–37.) It did recognize that a fund held to meet the general operating expenses of a business is not such a reserve as is contemplated by Section 201 (a). (R. 31–32.) But it held that its decision in *Reliance Benefit Assn.* v. *Commissioner,* 2 T. C. 15, dismissed, 143 F. 2d 597 (C. C. A. 9th), was controlling that the reserve fund maintained qualified as a true life insurance reserve within Section 201 (a). (R. 35.) However, since the *Reliance* case neither considered nor decided whether a reserve fund, shown to have been held for various purposes, of which fulfillment of insurance contracts was only one, qualified as a reserve fund under Section 201 (a),[10] that case can not be dispositive of the present

[10] The point actually decided in the *Reliance* case was that a reserve was required to be established by Arizona law and that the fund prescribed complied with the reserve requirement of the statutory definition, since the prescribed reserve was equivalent to reserves based on experience tables and would enable the company to liquidate its policies as they matured. In view of the decision of the Supreme Court of Arizona in *Pioneer etc. Assn.* v. *Corporation Com.*, 59 Ariz. 112, 123 P. 2d 828, and the finding in this case that the Arizona Corporation Commission required a benefit company to hold in reserve 50% of all premiums after the first year (R. 26), we do not argue that the taxpayer was not required by law to maintain a reserve fund to the extent of 50% of premiums

case. As the minority opinion here points out (R. 39), even if the point lurked in the record there, the *Reliance* opinion is not authority here, since the point was not decided.[11]

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collected after the first year. Nor do we contend that the reserves must have actually been computed on an actuarial basis, in view of the Tax Court's findings that the Corporation Commission deemed a reserve equal to 50% of premiums after the first year sufficient to meet all requirements of standard mortality tables at a 3½% interest accretion rate; that it submitted all policies to an actuary to see if they met its rules with respect to reserve funds; and that the taxpayer has since 1937 been examined each year and met the Commission's requirements. (R. 26.) See footnotes 4 and 5, *supra;* Cf. Section 19.203 (a) (2)–1 of Treasury Regulations 103; *General Life Ins. Co.* v. *Commissioner*, *supra.*

[11] In a memorandum opinion entered June 8, 1943, under the name of *Pioneer Mutual Benefit Assn.* v. *Commissioner* (1943 P–H T. C. Memorandum Decisions, par. 43, 266), the Tax Court held that the *Reliance* case was controlling that a group of Arizona benefit corporations were to be classed as life insurance companies for the years 1937 and 1938. The present taxpayer was one of the group covered in the memorandum opinion and, although a protective petition for review was filed in this Court by the Government, it was subsequently dismissed on June 13, 1944, along with the petition for review in the *Reliance* case. See 143 F. 2d 596, 597 (C. C. A. 9th). The point presented now, however, was not presented to or decided by the Tax Court in its memorandum opinion. The earlier decision is not in any way *res judicata* of the present case. In the first place, this is not the sort of question to which the principle of *res judicata* applies. A decision determining a taxpayer's classification for one tax year does not preclude reexamination as to its taxable status for other years. This is so, because the question of classification for each year under a statutory definition must be determined in light of the facts of that period, which, even though similar, are not the same facts as are involved in a determination of status for other years. See *Henricksen* v. *Seward*, 135 F. 2d 986 (C. C. A. 9th); *Corrigan* v. *Commissioner*, 155 F. 2d 164 (C. C. A. 6th); *Stoddard* v. *Commissioner*, 141 F. 2d 76 (C. C. A. 2d); *Monteith Bros. Co.* v. *United States*, 142 F. 2d 139 (C. C. A. 7th); *Commissioner* v. *Netcher*, 143

However, even if the Tax Court understood that only a reserve fund held exclusively for fulfillment of contracts would serve to bring the taxpayer within the definition of a life insurance company in Section 201 (a), it failed to apply that principle here. Although it concluded that the taxpayer maintained [12] a mortuary or reserve fund for the payment of claims arising from its contracts, as required by Arizona law, it did not hold that the reserve fund was held exclusively for the payment of such claims. Nor could it have so

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F. 2d 484 (C. C. A. 7th), certiorari denied, 323 U. S. 759; *Engineer's Club of Philadelphia* v. *United States*, 42 F. Supp. 182 (C. Cls.), certiorari denied, 316 U. S. 700; cf. *Commissioner* v. *Security-First Nat. Bank*, 148 F. 2d 937 (C. C. A. 9th).

Furthermore, even if the doctrine of *res judicata* were properly applicable to the type of question involved in this case, contrary to the holding in the above cases, the doctrine would not preclude decision of the point argued here, since this point was not decided in the earlier case. Because the present controversy involves taxes for a different year than did the earlier one, a different claim or demand is involved, and only issues actually litigated and decided in the earlier case can operate as an estoppel. *Tait* v. *Western Md. Ry. Co.*, 289 U. S. 620, 623. Also, the taxpayer has not pleaded that the earlier decision is *res judicata*, so that such a question is not in issue here.

[12] Although it might be questioned from the testimony whether a mortuary or reserve fund was in fact maintained, the Tax Court found that the taxpayer carried a mortuary fund and an expense fund on its books, to which it allocated premiums as received, and that it held actual assets in reserve for claim purposes in excess of the reserve shown in its mortuary fund. (R. 26–29.) Furthermore, its balance sheets for December 31, 1938, and December 31, 1939, carried as a liability amounts listed as "Reserve for future death claims." (R. 107.) Hence, the taxpayer here did more than merely to classify its income as did the taxpayer in *First Nat. Ben. Soc.* v. *Stuart*, 134 F. 2d 438 (C. C. A. 9th), certiorari denied, 320 U. S. 211, wherein this Court held that no reserve fund was in fact maintained.

concluded upon its findings, which show beyond any doubt that the fund was subject to be used for a variety of payments, which were not the fulfillment of contracts.

However, before discussing in detail the several purposes for which the assets in the mortuary fund could be disbursed, it is observed that the Tax Court found that the taxpayer maintained only two funds, a mortuary fund, and an expense fund which plainly is not a reserve fund, as the Tax Court held. (R. 31.) Although the mortuary fund was held in part to fulfill insurance contracts, the assets held for this purpose were not segregated from the total of the assets held in the mortuary fund, which was subject to use for the additional purposes to be discussed. Also, no such segregation of assets was made on the books nor was the total amount in the mortuary fund divided on the books between the various accounts for which it could be used. Furthermore, the premiums allocated to the mortuary fund were not even classified as between the items for which they were to be held. Hence it follows that the taxpayer in fact maintained no separate fund, within its general mortuary fund, solely for payment of claims, nor did the Tax Court so find. See both *First Nat. Ben. Soc.* v. *Stuart* decisions of this Court, *supra*.

(1) The taxpayer's insurance policies expressly provided that designated percentages of premiums collected (after the first month) were to be placed in a reserve or mortality fund "for the purpose of payment of claims and expenses incidental thereto."

(R. 23, 92–93.) Section 53–609 (b) of the Arizona Code (Appendix, *infra*) also permitted the reserve fund which was set up to be used to pay "attorney's fees and necessary expense arising out of the defense, settlement, or payment of any contested or disputed claim." (R. 25.) There was no statutory limit and apparently no other restriction upon the amount of the attorney's fees which could be paid from the reserve fund, and the only restriction on payment of the expenses arising out of a contested claim was the statutory one that they be necessary. (Cf. testimony of Betts, R. 121.)

Since the mortality fund was held and could properly be used for these purposes it cannot be considered as a reserve fund exclusively for the fulfillment of contracts. See the second *First Nat. Ben. Soc.* v. *Stuart* case, *supra*. See also Sol. Op. 76, 3 Cum. Bull. 276 (1920), ruling that a reserve for the expense of investigating and settling loss claims of a casualty insurance company was not a true reserve. It was there pointed out that expenses of investigating claims are in fact ordinary running expenses of insurance companies, and a reserve for this purpose is not maintained to liquidate claims of policyholders, unless indirectly, by protecting the company's business from unnecessary loss. Cf. *Maryland Casualty Co.* v. *United States,* 251 U. S. 342; Section 19.203 (a) (2)–1 of Treasury Regulations 103.[13]

[13] In footnote 9, *supra*, it was pointed out that in *General Life Ins. Co.* v. *Commissioner*, 137 F. 2d 185 (C. C. A. 5th), the court held that a reserve from which expenses of investigating and contesting claims could be paid, limited however to 7.2% of the premium income, qualified as a reserve fund within Section 201 (a).

Furthermore, as the dissenting opinion of the Tax Court suggests (R. 38), the statutory authority to use the fund to pay attorney's fees and necessary expenses arising out of the defense of a contested or disputed claim without any limitation as to amount stamps the fund as held for a purpose in direct antithesis to "fulfillment" of contracts.

The circumstances pointed out by the Tax Court (R. 32) that the expenses actually paid were related to a specific policyholder, were incidental to settlement of claims, were not excessive,[14] and did not reduce the reserves to an amount less than that required by law are not decisive. If the statute requires, as we have shown, that the reserve fund be held for one purpose only, a fund does not meet the statutory test if other items have properly been charged to this fund, no matter how reasonable in amount in connection with a particular claim they may be and no matter if the fund remaining for fulfillment of contracts after such expenses are paid exceeds the legal requirements.

(2) Section 53–609 (b) of the Arizona Code also authorized the payment from the reserve fund of "the deposits required to be made with the state treasurer as provided by Section 53–605." Section 53–605 (Appendix, *infra*) provides for deposit with the state treasurer, to be held in trust for the benefit and pro-

[14] The claim expenses actually paid out of the mortuary fund appear to have totalled $104.13 in 1939 and $436.45 in 1940. (R. 16, 18, 26–27.) Exhibit F (R. 112–117) shows the charges and credits to the mortality fund in detail for a period commencing in 1938 and ending in 1941.

tection of the corporation's members, of $1,000 before the company receives a certificate of authority to transact business; the deposit of a further amount of $1,000 within a year thereafter, and of a further amount each year equal to one dollar for each $1,000 of protection in force on December 31 of the preceding year, until a total of $10,000 has been deposited. The section further provides:

> (e) Said deposit may be considered as a part of any required reserve of the corporation and shall not be subject to withdrawal so long as the corporation has any contract or other liability outstanding. If and when the corporation liquidates, dissolves, or merges with another corporation, and there are no certificates or other liabilities not satisfied or assumed, the deposit shall be returned to the corporation upon the order of the commission, and placed to the credit of the fund from which it was taken or paid to the person who may have advanced it.

Thus, the amount deposited was not withdrawable by the depositing corporation during its legal existence or while it had any contract or other liability outstanding. The necessary result is that the deposit was not available at all for fulfillment of insurance contracts, since the depositor must have satisfied, i. e., fulfilled, all its contracts before it could withdraw the fund. The deposit was, however, subject to the lien of any final judgment of an Arizona court and therefore might be reached by general creditors. (Section 53–605 (d) (Appendix, *infra*).) The deposit was clearly one made for the benefit of the corporation's members,

as stated in Section 53–605, as distinguished from one for satisfaction of insurance claims. In *Maryland Casualty Co.* v. *United States,* 251 U. S. 342, the Supreme Court pointed out that a reserve in the technical sense is held, not only as security for payment of claims, but also as a fund from which the claims themselves are to be paid. The amount deposited with the state therefore was not a reserve fund held for fulfillment of contracts within the meaning of Section 201 (a).[15] Cf. also *Midland Nat. Life Ins. Co.* v. *Commissioner,* 14 B. T. A. 200, and *Kaskaskia Life Ins. Co.* v. *Commissioner,* 22 B. T. A. 210, dismissed *sub nom. Mississippi Valley Life Ins. Co.* v. *Commissioner,* 62 F. 2d 1075 (C. C. A. 8th).

Thus, the mortuary fund could be, and was in the taxable years (R. 54), depleted by payments into the deposit with the State treasurer, which payments themselves were in no sense in fulfillment of contracts, and which did not establish or maintain a reserve fund for the purpose of fulfilling contracts. In its opinion the Tax Court made no reference to these facts, but it seems indisputable that the legal authority to charge

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[15] This conclusion is not in conflict with Section 202 (b) of the Internal Revenue Code, *supra*, which provides that in the case of assessment insurance the term "reserve funds required by law" includes sums actually deposited with state officers, pursuant to law as "guaranty or reserve funds." Thus, it is implicit that the deposit must be made as a guaranty or reserve in the accepted insurance sense, that is, to mature or liquidate claims on contracts. Where, as here, the deposit was never available for payment of claims, there was no sum whatever deposited with the state treasured as "guaranty or reserve funds." Consequently, the deposit here is not the sort referred to by Section 202 (b).

the mortuary fund in this way establishes that it was held for a purpose which does not comply with the statutory test. See the second *First Nat. Ben. Soc.* v. *Stuart* case, *supra.*

(3) Article XVI of the taxpayer's by-laws authorized its directors to set aside a portion of the savings in the death benefit fund, i. e., the mortuary fund, for the purpose of organizing a legal reserve life insurance company. (R. 23–24.) This provision was to carry out one of the purposes of the taxpayer as stated in Article III of its by-laws. (R. 99.) It is obvious that a payment for this purpose could have no relation to the fulfillment of the taxpayer's contracts. It would represent an expense of a general nature. A fund held for this purpose is not an insurance reserve (cf. *Maryland Casualty Co.* v. *United States,* 251 U. S. 342; Section 19.203 (a) (2)–1 of Treasury Regulations 103) and is not held for fulfillment of contracts. As J. Disney, dissenting, stated (R. 38):

> I am altogether unable to comprehend how a mortuary fund, subject to be drawn upon to set up a legal reserve life insurance company can be said to be held for the fulfillment of the insurance contracts.

It is noted that the majority opinion did not even mention this important fact.

As already observed, the circumstance that the fund may not have been debited in the taxable years with the expenses of organizing a legal reserve company[16]

[16] Actually the record is not clear that expenses of this nature were not paid in the taxable year. (R. 80–81.)

is irrelevant. The mortuary fund was established and was "held" to pay such expenses, whether or not any were incurred during a particular year.

(4) Article XVI of the taxpayer's by-laws required the directors to issue each year to each member whose payments had not lapsed a certificate showing the member's share in the savings in the mortuary fund. (R. 24.) Under this provision the taxpayer was required by the Arizona Corporation Commission to make refunds to policyholders of premiums collected in excess of the cost of insurance out of the mortality fund, and the amounts so refunded ($1,597.93 in 1939 and $4,154.18 in 1940) were treated in its books as dividends. (R. 26, 27–28.) Quite clearly a fund subject to be depleted by the amounts of excess premiums in the nature of dividends is not a reserve fund held for fulfillment of insurance contracts. Compare the cases which decide that a reserve held to pay dividends or coupons representing dividends to policyholders are mere liability or solvency reserves and not life insurance reserves in the technical sense. *New York Life Ins. Co.* v. *Bowers,* 283 U. S. 242; *Helvering* v. *Inter-Mountain Life Ins. Co.,* 294 U. S. 686; *Helvering* v. *Montana Life Ins. Co.* 84 F. 2d 623 (C. C. A. 9th); *Continental Assur. Co.* v. *United States,* 8 F. Supp. 474 (C. Cls.); *Massachusetts Mut. Life Ins. Co.* v. *United States,* 56 F. 2d 897 (C. Cls.); *Minn. Mutual Life Ins. Co.* v. *United States,* 66 C. Cls. 481, certiorari denied, 279 U. S. 856; *Equitable Life Assurance Society* v. *Commissioner,* 33 B. T. A. 708, 716–717;

Midland Mut. Life Ins. Co. v. *Commissioner,* 19 B. T. A. 765. See Section 19.203 (a) (2)–1 of Treasury Regulations 103, which provides that the term reserves does not include amounts maintained for annual and deferred dividends.

The Tax Court seems to have recognized that the payment of these dividends from the mortuary fund was not a payment to fulfil contracts. However, it attempted to justify its holding that the mortuary fund was held to fulfil contracts on the theory that the payment of dividends did not in fact reduce the reserve in the taxable years below legal requirements. (R. 32.) But this, of course, is immaterial to the issue under the statute. Since the taxpayer maintained only one "reserve" fund, its mortuary fund, and since this fund was subject to invasion for premium refunds, it does not meet the statutory test which specifies a reserve fund held only to fulfil contracts.

(5) Section 53–609 (b) of the Arizona Code permitted the interest earned by the assets of the corporation, whether deposited with the state treasurer or otherwise invested, to be used for general operating expenses. No exception is made of interest (R. 25) earned on the assets set aside in a reserve fund. This, we submit, authorizes use of the mortuary fund for such expenses, for the reason that interest earned by the assets comprising a reserve fund is considered as a part of the fund. The classic definition of a reserve fund, stated in *Maryland Casualty Co.* v. *United States, supra,* and incorporated in Section 19.203 (a) (2)–1

of Treasury Regulations 103, is that it is a sum of money, variously computed or estimated, which with *accretions from interest,* is set aside to mature or liquidate future unaccrued and contingent claims. The regulation also states that only funds dependent upon interest earnings for their maintenance will be considered as reserves. And Congress has always considered interest on the reserve fund as of the same character as the principal of the fund, so far as protection for policyholders is concerned. See for a full discussion, *Commissioner* v. *Monarch Life Ins. Co.,* 114 F. 2d 314 (C. C. A. 1st). See also *Helvering* v. *Oregon Ins. Co.,* 311 U. S. 267, 269; *Massachusetts Mut. Life Ins. Co.* v. *United States,* 56 F. 2d 897, 899 (C. Cls.).

As the District Court held in the second *First Nat. Ben. Soc.* case, *supra,* affirmed by this Court, the permission to use interest accretions from reserve funds for general expenses violates the requirements for an insurance reserve fund set out in Section 19.203 (a) (2)–1. While *Jones* v. *Oklahoma Ben. Life Assn.,* 151 F. 2d 505 (C. C. A. 10th), held that authority to use the interest earned by the fund involved in that case for general expenses did not prevent the fund from qualifying as a reserve fund held to fulfil contracts, this conclusion was reached because (p. 509)—

> Under the Oklahoma statutes and the by-laws of the Association, interest earned by the emergency fund of the Association does not accrue to the fund and is no part thereof. Hence,

> use of the interest for expenses cannot be said to be a use of the fund.[17]

In the instant case Section 53–609 (b) of the Arizona law does not provide that interest earned shall not be part of the mortuary or reserve fund. Nor do the taxpayer's by-laws so provide. Article XVI (R. 23–24) merely prescribes a death benefit fund and an expense fund, but does not stipulate that all interest earned shall go into the expense fund. On the contrary, it is stated that the expense fund shall consist of *only* membership and registration fees, first month's payments of assessments and reinstatements, 50 percent of the following eleven months' payments and 33⅓ percent of all subsequent payments, thus excluding interest earned by the mortuary fund. Thus, the case at bar presents a factual situation with respect to interest different from that in the *Oklahoma Benefit* case.[18]

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[17] Section 2 (b) of Article II of the Oklahoma Association's by-laws provided:

> Any interest accruing from the investment of such funds [reserve fund assessments] shall be collected by the Secretary or Treasurer and become a part of the general expense fund of the Association.

See *Oklahoma Ben. Life Ass'n* v. *Jones*, 57 F. Supp. 423, 426 (W. D. Okla.).

[18] Although not directly involved here, we doubt the correctness of the conclusion in the *Oklahoma Life* decision, since we think the authorities cited above establish that the interest accretion element is a necessary factor to classify a fund as a true insurance reserve held for fulfillment of contracts within the meaning of Section 201 (a). While the Fifth Circuit has held that a reserve fund may be "variously computed or estimated," as the regulation says, it has not dispensed expressly or by implication with the requirement that the fund shall be maintained by

We submit that on the record here the authority to use interest earned by the assets in reserve for general expenses constitutes an authority to use the mortuary fund for such a purpose and prevents the fund from meeting the criteria for a reserve fund contemplated by the statutory definition.

(6) The balance in the taxpayer's mortuary fund as of December 31, 1939, of $14,659.57 (R. 26–27) included a provision of $149.58 for hospitalization on future sick and accident claims (R. 109). Although the exact amount held for this purpose is shown, no separate reserve was in fact maintained to pay hospitalization claims. There are no figures showing the provision for hospitalization in the fund as of December 31, 1940; however, that some amount was included is clear, since an erroneous allocation to the fund for hospitalization was eliminated in 1940. (R. 27.) A reserve held to pay sick and accident claims is not a life insurance reserve fund, although a separate reserve for this purpose may be considered as part of the "total reserve funds" referred to in Section 201 (a). See *National Protective Ins. Co.* v. *Commissioner,* 128 F. 2d 948 (C. C. A. 8th), certiorari denied, 317 U. S. 655; *Kaskaskia Life Insurance Co.* v. *Commissioner,* 22 B. T. A. 210, appeal dismissed *sub. nom. Mis-*

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interest accretions. Indeed, under the Texas law involved in *General Life Ins. Co.* v. *Commissioner*, 137 F. 2d 185, and *Abilene Life Ins. Co.* v. *Commissioner*, 137 F. 2d 191, it seems to have been required that interest should be added to the principal of the reserve fund and held for the same purpose. The record in the *General Life* case shows that the state insurance commissioner so testified.

sissippi Valley Life Ins. Co. v. *Commissioner,* 62 F. 2d 1075 (C. C. A. 8th).

As previously pointed out, the taxpayer's mortuary fund was not segregated into a fund, or assets, held to liquidate policy claims and funds held for the several other purposes just discussed. Thus, the mortuary fund was no more than a general fund to meet all the expenses and charges properly payable therefrom. Since, as has been shown, the purposes for which the mortuary fund was held include many, in addition to payment of claims, which entirely violate the concept of life insurance reserves, the fund cannot qualify as a reserve fund held for fulfillment of contracts within Section 201 (a). Cf. the two *First Nat. Ben. Soc.* cases, *supra.*

Moreover, even if it were assumed *arguendo* that some portion of the mortuary fund was held exclusively to fulfil contracts, not only was no separation of a reserve fund for this purpose made in fact within the mortuary fund itself, which would be necessary for taxpayer to prevail, but there was no showing as to even the approximate percentages of the fund held in reserve for this and other purposes.[19] Indeed, it does seem that such an approximation would not be helpful, since there was apparently no limit on amounts usable for expenses of settling and contesting claims and attorney's fees. Also, all the fund attributable

[19] An exception is in the case of the amount held to pay hospitalization claims in 1939 (R. 109), but there was merely a classification within the mortuary fund itself, no separate fund being in fact maintained. For 1940 the record does not show even a separate classification of the hospitalization claim reserve. (R. 111.)

to interest was expendable for general expenses. Even if the view were taken that the portion of the mortuary fund attributable to 50% of premiums collected on all policies after the first year was necessarily held for policy claims, on the theory that the Arizona Corporation Commission prescribed this amount as the minimum reserve requirement (a view which is not tenable since even this minimum amount would be subject to use for expenses), the record does not show what this amount would be.

There is thus no basis on which it could be concluded that more than 50% of the mortuary fund was held to fulfil death claims. To be sure, the actual payments in the taxable years for other purposes seems to have been less than 50% of the total fund,[20] but this supplies no proof that more than 50% of the balance of the fund was held for fulfillment of contracts, as distinguished from other purposes for which the fund could lawfully be used.

It is true that the Tax Court concluded that more than 50% of taxpayer's total reserve funds was held for fulfillment of its life insurance contracts. (R. 29.) However, this conclusion did not result from an apportionment of the mortuary fund, but was based on

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[20] The analysis of the mortuary fund given in the Tax Court's findings (R. 26–27) fails to show the expenses paid in connection with death claims ($104.13 in 1939 and $436.45 in 1940—R. 16, 18) which are included in the amounts shown as paid out for (death) claims, nor does it disclose amounts deposited with the state treasurer in those years ($167.67 in 1939 and $789.47 in 1940), or expenses, if any, paid to organize a legal reserve company or paid from interest in 1940 (see R. 54, 80–81).

the erroneous holding that the mortuary fund was a reserve fund held for fulfillment of contracts within Section 201 (a), and since the taxpayer had no other reserve fund, that it also represented its total reserve fund. Consequently, the mortuary fund was more than 50%, i. e., all, of the total reserve funds. Since we have shown that the mortuary fund was not a reserve fund held for fulfillment of contracts, it follows that the Tax Court's conclusion must fall and that taxpayer does not fit within the definition of a life insurance company.

II

The taxpayer is taxable under section 207 of the Internal Revenue Code and is liable for deficiencies as determined by the Commissioner

It remains to consider briefly the Commissioner's determination that the taxpayer is liable for deficiencies as a mutual insurance company taxable under Section 207 of the Internal Revenue Code (Appendix, *infra*). If, as has been shown, it is not taxable as a life insurance company, it clearly should be classed as a mutual insurance company other than life or marine. It was a non-profit insurance company (R. 22) and undertook to furnish insurance to its members at cost, refunding excessive premiums to them. It thus was a mutual company. See *American Ins. Co. of Texas* v. *Thomas,* 146 F. 2d 434 (C. C. A. 5th), and cases cited.

The Tax Court stated (R. 30) that the taxpayer conceded there is a deficiency if the reserves it main-

tained are not reserves "required by law" and if it falls under Section 207. We take this to be a concession that the deficiencies are as determined by the Commissioner, if the taxpayer's mortuary fund is held not to be a true reserve fund under the law and the regulations. But in any case this is the necessary conclusion.

The only issue raised (see petition, R. 5–7) under Section 207 was whether the taxpayer was entitled to a deduction under Section 207 (c) (1) (A) (Appendix, *infra*) which the Commissioner had not allowed it in computing the deficiencies. That section grants mutual insurance companies other than life an additional deduction for—

> the net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State of Territorial officers pursuant to law as additions to guarantee or reserve funds); * * *

The complete answer to the claim for deduction under this section is that no addition whatever was made to "reserve funds" in the taxable year, because the mortuary fund was not a reserve fund. Furthermore, there is no evidence whatever as to the amount of the net addition, if any, required by the rules of the Arizona Corporation Commission to be made in the taxable years to the mortuary fund. Although the amounts deposited with the state treasurer in 1939 and 1940 were shown, the taxpayer is entitled to no deduction therefor, because the sums were not

deposited as additions to a guarantee or reserve fund. As has been shown, the deposit was only a fund to protect members, and in no sense a reserve fund to liquidate insurance claims.

CONCLUSION

The decision of the Tax Court should be reversed, with instructions to find deficiencies as determined by the Commissioner.

Respectfully submitted,

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DECEMBER, 1946

APPENDIX

Arizona Code Annotated (1939):

53–601. *Short Title.*—This act may be cited as the Benefit Corporation Law of 1937. [Laws 1937, ch. 36, § 1, p. 107.]

53.602. *Benefit corporations.*—Corporations, not for pecuniary profit, may be formed to provide cash benefits for members and cash benefits for the nominees of deceased members, and shall include all corporations, societies and associations operating an insurance business where funds are provided by mutual contributions, periodical payments, dues or assessments, except those hereinafter exempted. [R. S. 1901, § 898; 1913, § 2215; R. C. 1928, § 607; Laws 1937, ch. 36, § 2, p. 107.]

53–603. *Formation.*—(a) Two hundred [200] or more citizens of the United States, residents of this State for at least one [1] year, may form a benefit corporation by filing articles of incorporation, verified by each of them, stating the general objects of the corporation, its principal place of business, the time of its commencement and termination, the names of the directors and officers by whom the affairs of the corporation are to be conducted and the time of their election, the corporation's name (which shall indicate its general character of business and shall not closely resemble the name of any association, life insurance company, or corporation now licensed to do business in this State), and whether private property is to be exempted from liability for the corporate debts.

(b) When the articles of incorporation have been thus filed and a certified copy thereof

recorded in the office of the county recorder of the county in which its place of business is situated, and appointment of a statutory agent filed, the corporation commission shall issue the corporation a certificate of incorporation. [R. S. 1901, § 889; 1913, § 2216; R. C. 1928, § 608; Laws 1937, ch. 36, § 3, p. 107.]

53–604. *Minimum membership.*—Such corporation shall have twelve [12] months from the date of its certificate of authority to secure a minimum of not less than five hundred [500] members in good standing. Should the membership at any time fall below said minimum, the corporation shall immediately notify the corporation commission. Within ninety [90] days thereafter, or such further time as the commission may allow, the corporation shall increase its membership to said minimum. If the corporation fails to increase its membership within the time fixed, the commission shall revoke its certificate of authority and thereupon such corporation shall liquidate and dissolve. [R. C. 1928, § 608a as added by Laws 1937, ch. 36, § 4, p. 107.]

53–605. *Deposit of money or security.*—(a) Every benefit corporation organized or operating under the provisions of this act, before receiving a certificate of authority to transact business, shall in addition to the requirements of section 609b [§ 53–611], deposit with the state treasurer, to be by him held in trust for the benefit and protection of the corporation's members, the sum of one thousand dollars [$1,000]. Thereafter a further sum of one thousand dollars [$1,000], divided into twelve [12] equal monthly payments, beginning thirty [30] days after the certificate of authority is issued, shall be likewise deposited with the state treasurer. Failure to pay any such monthly payment shall automatically cancel the corporation's certificate of authority.

(b) In addition to said deposits every such corporation shall, not later than February 1, 1940, and on or before February 1 of each year thereafter, deposit with the state treasurer, to be by him held in trust as hereinafter provided, for the benefit and protection of the members of the corporation, a further sum equal to one dollar [$1.00] for each one thousand dollars [$1,000] of protection in force on December 31 of the preceding year, beginning as of December 31, 1939, until a total of ten thousand dollars [$10,000] has been so deposited.

(c) The deposits prescribed by this section shall be subject to withdrawal from the state treasury in whole or in part only on the order of and as directed by the corporation commission, but may, with the commission's approval, be invested in United States or state bonds, which shall be placed with and assigned to the state treasurer and held by him as provided for the original deposits. Subject to approval by the commission any such securities may be exchanged for others of like amounts. The interest on said securities shall be payable to the corporation depositing the same.

(d) Any unsettled final judgment of a court of this state shall be a lien on the deposits of money or securities prescribed by section 608b [§ 53–605], and subject to execution after thirty [30] days from entry of final judgment. If said deposit is depleted thereby it shall be replenished within ninety [90] days.

(e) Said deposit may be considered as a part of any required reserve of the corporation and shall not be subject to withdrawal so long as the corporation has any contract or other liability outstanding. If and when the corporation liquidates, dissolves, or merges with another corporation, and there are no certificates or other liabilities not satisfied or assumed, the deposit shall be returned to the corporation upon the order of the commission,

and placed to the credit of the fund from which it was taken or paid to the person who may have advanced it. [R. C. 1928, § 608b as added by Laws 1937, ch. 36, § 5, p. 107.]

53–606. *Benefit certificate.*—(a) Every benefit certificate issued by any such corporation shall specify the maximum amount not exceeding five thousand dollars [$5,000], on the life of any individual, to be paid on the happening of the contingency therein stated, and shall state the basis or amount to be set aside to the mortuary and reserve fund. The certificate, including any written amendment thereto, and, at the option of the corporation, the application therefor, and the bylaws of the corporation, shall constitute the entire contract between the corporation and the member, and the applicant shall see that all facts required to be stated are set forth in the application.

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53–609. *Payments and funds.*—(a) Every benefit corporation shall provide in its benefit certificate for periodical payments or dues sufficient to pay benefit claims and general operating expenses as stipulated therein.

(b) A mortuary and reserve fund, exclusive of other assets, may be created, out of which may be paid all benefit claims arising under the certificates, the deposits required to be made with the State treasurer as provided by section 608b [§ 53–605], and attorney's fees and necessary expenses arising out of the defense, settlement, or payment of any contested or disputed claim. The residue of payments made by members, after setting aside the amount required for the mortuary and reserve fund, and interest earned by the assets of the corporation, whether deposited with the State treasurer or otherwise invested, may be used for general operating expenses. [R. S. 1901, § 900; 1913, § 2217; rev., R. C. 1928, § 609; Laws 1937, ch. 36, § 9, p. 107.]

53–610. *Examination.*—At least once in every two [2] years the corporation commission shall require the books and the affairs of each benefit corporation to be examined and audited by an accountant designated and commissioned by it, for the purpose of verifying the funds as provided in the benefit certificate thereof. For such purpose the commission and its auditor shall have free access to all books, papers and accounts of the corporation. The cost of any such examination and audit shall be paid by the corporation, but it shall not be required to pay for more than one [1] such examination and audit in any one [1] year, nor to exceed twenty-five dollars [$25.00] for each one thousand [1,000] certificates or fraction thereof in force at the time of such examination except that a corporation chartered under the laws of another state shall also pay the traveling expenses of the accountant designated by the commission. All such costs shall be paid upon the completion of the audit or examination. [R. C. 1928, § 609a as added by Laws 1937, ch. 36, § 10, p. 107.]

53–611. *Certificate of authority to transact business.*—(a) Before any benefit corporation shall solicit applications for benefit certificates it shall file a copy of its certificate with the corporation commission and evidence that it has made the deposit required by section 608c [§ 53–606]. If the certificate conforms to the requirements of this act, the commission shall within three days issue a written certificate of authority to the corporation to transact business.

(b) Upon presentation to the commission of prima facie evidence that any benefit corporation is wilfully violating the provisions of this act, the commission shall immediately notify such corporation, stating the manner in which it is alleged the law is being violated. If it appears to the commission that the corporation

is continuing such violation, it shall cite the corporation to appear within thirty [30] days to show cause why the alleged violations should not be remedied. If upon said hearing the commission shall find that the corporation is violating the provisions of this act in the particulars stated in the citation, it shall serve a written notice of its decision upon the corporation, which shall be subject to the rights of appeal hereinafter provided. Should the corporation not appeal from such decision, or if it appeal and the appellate court shall uphold the decision of the commission, the corporation shall comply with the order of the commission within ten [10] days thereafter, and upon its failure so to do, the commission may revoke the certificate of authority of such corporation. [R. C. 1928, § 609b as added by Laws 1937, ch. 36, § 11, p. 107.]

53–612. *Exemption from attachment.*—No money paid or to be paid for any benefit, as provided in a certificate issued by a corporation organized or operating under the provisions of this act, shall be liable to attachment or other process, nor may it be seized, taken, appropriated or applied by any legal or equitable process, nor by operation of law to pay any debt or liability of any member of his nominee, except as may be provided in the benefit certificate. [R. C. 1928, § 609c as added by Laws 1937, ch. 36, § 12, p. 107.]

Internal Revenue Code:

SEC. 201. TAX ON LIFE INSURANCE COMPANIES.

(a) *Definition.*—When used in this chapter the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts

comprise more than 50 per centum of its total reserve funds.

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(26 U. S. C. 1940 ed., Sec. 201.)

SEC. 202. GROSS INCOME OF LIFE INSURANCE COMPANIES.

(a) *In General.*—In the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

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(b) *Reserve Funds Required by Law, Defined.*—The term "reserve funds required by law" includes, in the case of assessment insurance, sums actually deposited by any company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation of the company or association exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

(26 U. S. C. 1940 ed., Sec. 202.)

SEC. 203. NET INCOME OF LIFE INSURANCE COMPANIES.

(a) *General Rule.*—In the case of a life insurance company the term "net income" means the gross income less—

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(2) *Reserve Funds.*—An amount equal to 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ per centum shall be substituted for 4 per centum. Life insurance companies issuing policies covering life, health, and accident insur-

ance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, shall be allowed, in addition to the above, a deduction of 3¾ per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

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(26 U. S. C. 1940 ed., Sec. 203.)

SEC. 207. [as amended by Section 205 of the Revenue Act of 1939, c. 247, 53 Stat. 862]. MUTUAL LIFE INSURANCE COMPANIES OTHER THAN LIFE.

(a) *Imposition of Tax.*—

(1) *In General.*—There shall be levied, collected, and paid for each taxable year upon the normal-tax net income of every mutual insurance company (other than a life insurance company) a tax at the rates provided in section 13 or section 14 (b).

* * * * *

(c) *Deductions.*—In addition to the deductions allowed to corporations by section 23 the following deductions to insurance companies shall also be allowed, unless otherwise allowed—

(1) *Mutual Insurance Companies Other Than Life Insurance.*—In the case of mutual insurance companies other than life insurance companies—

(A) the net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and

(B) the sums other than dividends paid within the taxable year on policy and annuity contracts.

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(26 U. S. C. 1940 ed., Sec. 207.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.201 (a)–1. *Life insurance companies: Definition.*—The term "life insurance company" as used in chapter 1 is defined in section 201 (a). In determining whether an insurance company is a "life insurance company" as defined in section 201 (a), no reserve shall be regarded as held for the fulfillment of an insurance contract unless it conforms to the definition of "reserve" contained in section 19.203 (a) (2)–1.

SEC. 19.203 (a) (2)–1. *Reserve funds.*—In general, the reserve contemplated is a sum of money, variously computed or estimated, which, with accretions from interest, is set aside (reserved) as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims. It must be required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, but such requirement, without more, is not conclusive; for example, it does not include reserves required to be maintained to provide for the ordinary running expenses of a business definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance and unpaid brokerage; the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance; reserve for premiums paid in advance; annual and deferred dividends; accrued but unsettled policy claims; losses incurred but unreported; liability on supplementary contracts not involving life contingencies; estimated value of future premiums which have been waived on policies after proof of total and permanent disability.

In any case where reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the statute or insurance department ruling requiring that such reserves be held. Only reserves which are so required, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered. A company is permitted to make use of the highest aggregate reserve called for by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserve funds thereon be based upon recognized tables of experience covering disability benefits of the kind contained in policies issued by this particular class of companies. The deduction in respect of such reserve funds (not required by law) is 3¾ percent of the mean of such reserve funds held at the beginning and end of the taxable year.

SEC. 19.207–4. *Required addition to reserve funds of mutual insurance companies (other than life).*—Mutual insurance companies, other than life insurance companies, may deduct from gross income the net addition required by law to be made within the taxable year to reserve funds, including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds. Reserve funds "required by law" include not only reserves required by express statutory

provisions but also reserves required by the rules and regulations of State insurance departments when promulgated in the exercise of an appropriate power conferred by statute, but do not include assets required to be held for the ordinary running expenses of the business, such as taxes, salaries, reinsurance, and unpaid brokerage. Only reserves commonly recognized as reserve funds in insurance accounting are to be taken into consideration in computing the net addition to reserve funds required by law. In the case of a fire insurance company the only reserve fund commonly recognized is the "unearned-premium" fund. For a general definition of "reserve fund" see section 19.203 (a) (2)–1.

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